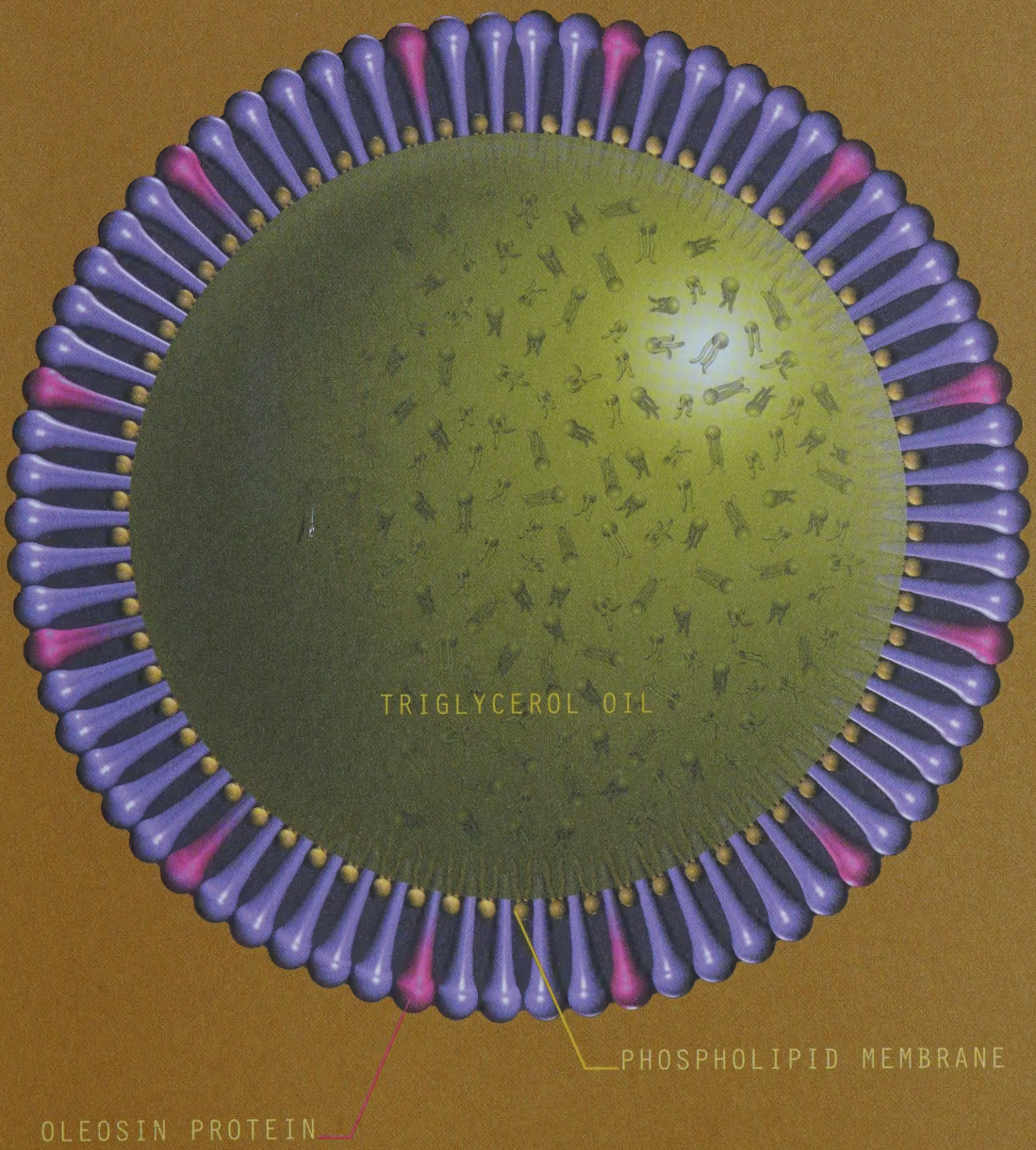
AR81

sembiosys



PROGRESS REPORT 2005

From scientific progress...

Scientific and medical research continually offers new possibilities, far reaching discoveries and revolutionary breakthroughs.

Deriving value from this work is frequently impeded by the economics of commercialization. High cost and scalability issues can obstruct the practical application of beneficial products.

...to practical results

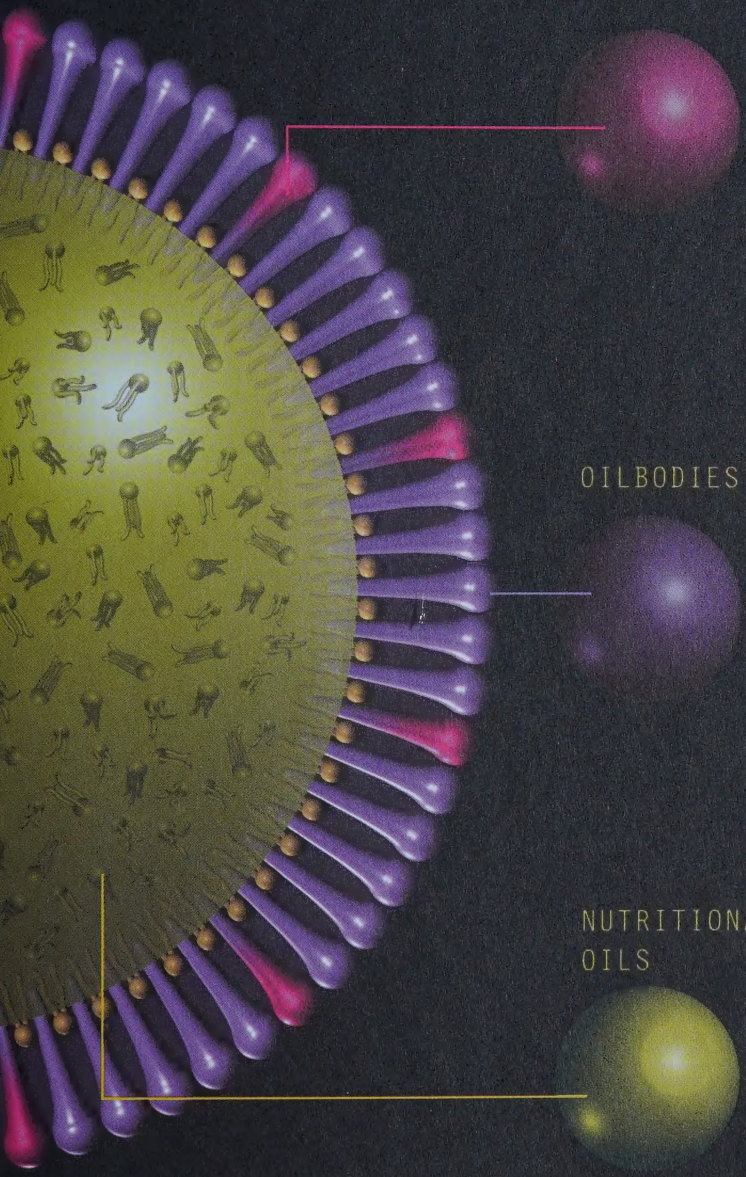
We offer a scalable, high-volume and economically-compelling plant-based solution. Whether for food or medicine, plants have always been a practical and scalable resource.

Our plant-based production platform has allowed us to develop a portfolio of pharmaceutical and non-pharmaceutical products at a much lower cost than current alternatives.

SAFFLOWER

SemBioSys uses safflower as its commercial vehicle for the production of pharmaceutical, animal and aquaculture health, topical ingredient and nutritional oil products. Our proprietary Stratosome™ Biologics System combines plant genetic engineering capabilities with production, extraction and purification processes. This combination allows us to manufacture products at substantially lower capital and operating costs than traditional bacteria or animal cell culture methods with unparalleled flexibility. Through the use of modern biotechnology, SemBioSys leverages the natural biomanufacturing advantages of safflower to enable the development of therapeutic proteins and non-pharmaceutical products that face cost and capacity barriers to commercialization.

PLATFORM



PROTEINS

SemBioSys' protein production technology addresses major challenges associated with the production and commercialization of certain biopharmaceuticals including high costs, heavy dosing regimes and the need for flexible, rapid and cost-effective scale-up of production.

OILBODIES

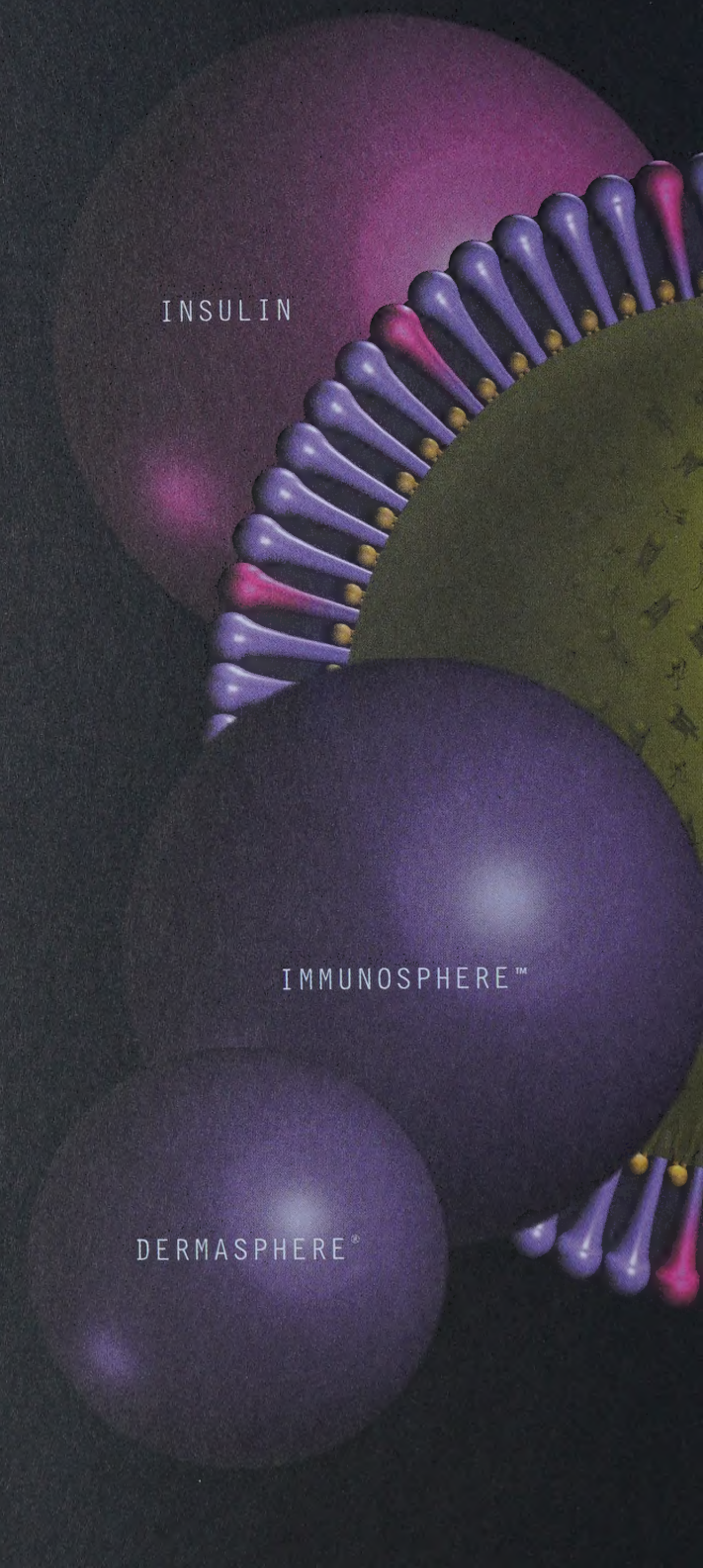
SemBioSys' proprietary oilbody extraction process produces non-transgenic oilbodies for topical applications. Oilbody products naturally form a surfactant-free, oil-in-water emulsion for use as a topical ingredient and as a carrier or delivery system for therapeutically active ingredients.

NUTRITIONAL OILS

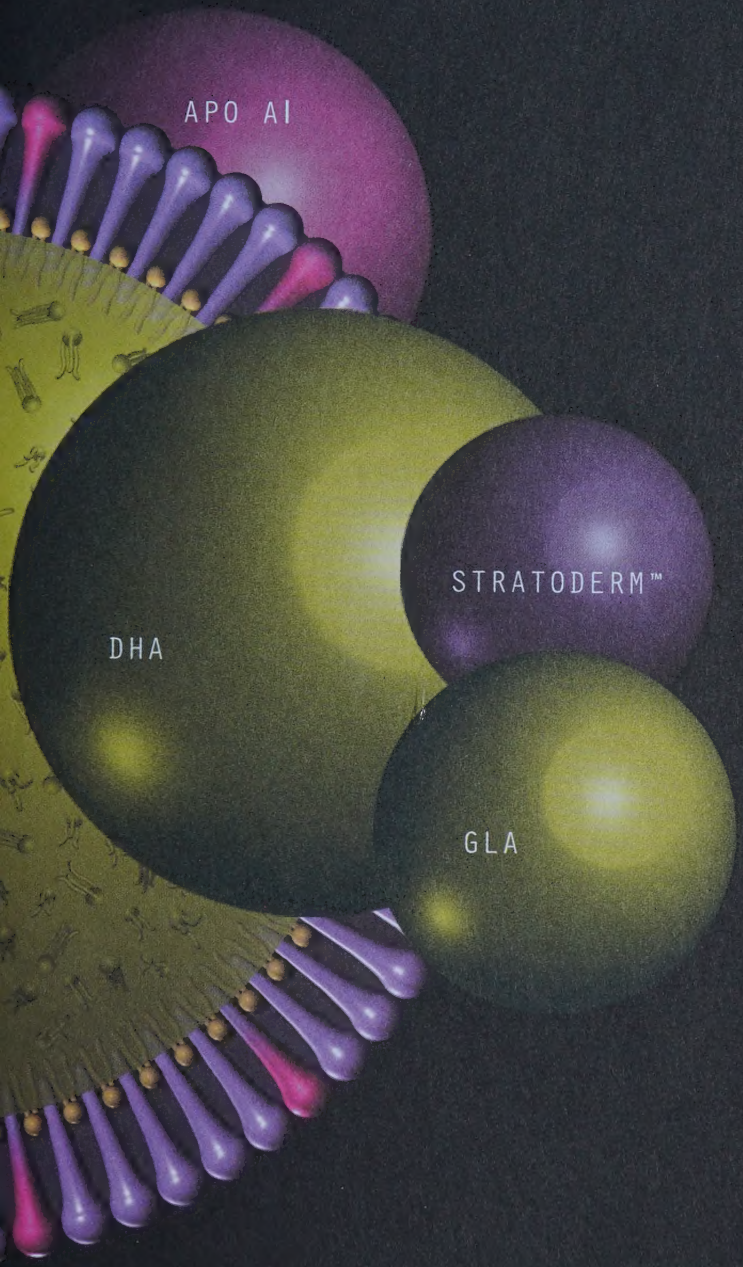
The natural core of an oilbody is vegetable oil. Nutritional oils containing polyunsaturated or essential fatty acids are gaining recognition as an important element of a healthy diet. Safflower is a potential low-cost, reliable and scalable source of higher value omega-3 and omega-6 oil products.

Based on our broad technology platform, we are developing a portfolio of pharmaceutical and non-pharmaceutical products. We have already commercialized our first product and are actively developing others to follow. These products are attracting strategic partners who provide complementary development and commercialization expertise. Since the fall of 2004, we have executed five major funded development agreements.

Our primary focus is the commercialization of our biopharmaceutical product candidates insulin and apolipoprotein AI (Apo AI), a cardiovascular drug. These products target large growing markets with the valuation metrics and margin opportunities typical of the biotechnology sector. Insulin is expected to follow an abbreviated drug approval process (505(b)(2)) while Apo AI will follow the typical clinical and regulatory procedure. Both processes will require time and support from strong partners for successful commercialization. We anticipate executing partnership agreements for these products as we move through the first stages of the clinical trial process.



PRODUCTS & PARTNERS



While we develop our biopharmaceuticals we are also developing several non-pharmaceutical products which will generate short- and intermediate-term revenue. These products face a less rigorous regulatory framework which reduces the time-to-market. In certain instances these near-term non-pharmaceutical product opportunities offer returns similar to the pharmaceutical candidates and provide a profitable business model on their own.

Sphere size = market opportunity
Sphere position = time to market

LETTER TO SHAREHOLDERS

Our oilbody-oleosin platform provides a series of product opportunities and represents an enabling technology that can transform the economics of protein production. The oilbody-oleosin technology combines the high volume/low cost production advantages of plants with the extraction and purification advantages of oilbody-based processing. Our long-term strategy for sustainable success is to leverage this platform to develop a stream of products that target growing markets.

While our primary focus is developing protein-based drugs, including insulin and apolipoprotein AI (Apo AI), aimed at the metabolic and cardiovascular markets, our technology also allows us to develop a wide range of non-pharmaceutical products. These non-pharmaceutical products validate our technology, build our product development infrastructure, provide short- and intermediate-term revenue and allow us to demonstrate to investors that we are tangibly building value. Our non-pharmaceutical products target the animal and aqua-culture health, topical ingredient and nutritional oil markets. The magnitude of the opportunities from these new emerging markets provides a profitable business model on their own. The potential returns from our non-pharmaceutical products offer down-side protection to compliment our pharmaceutical opportunities.

Our ImmunoSphere™ Feed Additive targets the $2.5 billion shrimp feed market. ImmunoSphere™ is an immunostimulatory protein feed additive that enhances protection against diseases in shrimp. Shrimp production is a large and growing industry with over $18 billion in annual shrimp exports. Disease is a significant threat to this market for shrimp producers, as a disease outbreak can devastate an entire region's shrimp production. In collaboration with our partner, Aqua Bounty Technologies, we are developing ImmunoSphere™. During 2004, Aqua Bounty launched its first shrimp feed additive product into the Mexican market and the response from shrimp producers has been strong. Our plant-produced ImmunoSphere™ is a second generation product meant to complement Aqua Bounty's current feed additive product. ImmunoSphere™ reduces production costs of the current product by up to 70%. We are currently scaling up production in Chile and later this year will begin another production cycle in North America followed by further increases in Chile to allow for sufficient quantities to initiate a commercial launch in 2007.

Our docosahexaenoic acid (DHA) rich safflower oil targets the growing nutritional oils market. DHA is an omega-3 fatty acid, commonly associated with fish oil, which is gaining prominence as an important ingredient in health-promoting foods. Sales of fish and plant-derived essential fatty acids grew to $440 million in 2004. In the first nine-months of 2005, 244 new omega-containing food products were introduced into the US market. Our partner in the DHA program is Martek Biosciences Corporation, the world's largest supplier of DHA. We continued our development progress on this program in 2005 and later this year expect results from work in Arabidopsis, our model plant system, which represents the key DHA proof-of-concept milestone.

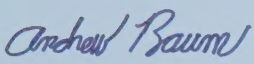
Our first commercialized product, DermaSphere® Oleosome Technology, was launched by our partner Lonza Inc. in 2004 in the personal care market. DermaSphere® is a topical ingredient used in Lonza's Natrulon® product line of naturally derived specialty blends that targets the growing consumer trend to use natural personal products. The initial response to Lonza's launch has been very positive. While DermaSphere® represents a modest revenue opportunity; it demonstrates our ability to work with our partners to successfully bring new products to market. We expect to begin receiving royalty payments during the first half of 2006.

Our ability to deliver on the promise of these three non-pharmaceutical products, that target growing markets, is supported by strong partners. Our partners provide complementary development and commercialization expertise to our development programs. Our progress on these three programs, together with our progress on the GLA rich safflower oil and animal vaccine programs with Arcadia Biosciences, Inc. and Dow AgroSciences LLC respectively, demonstrates the ability of our team to achieve development milestones and as a result, build value and attract the interest of potential new partners. Our non-pharmaceutical products represent strategic opportunities to each of our partners. In turn, they provide important pre-commercialization revenue, through royalties, research payments and milestone payments to continue the development of our pharmaceutical candidates, insulin and Apo AI.

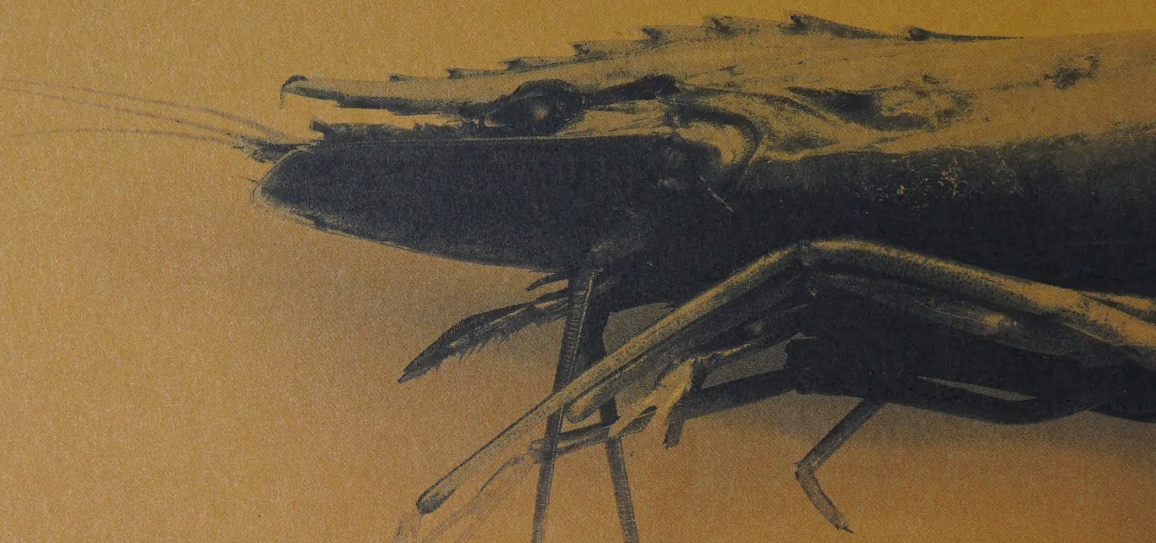
The recent US and European approval of Pfizer's Exubera® Inhalation Powder for the treatment of adults with Type 1 and Type 2 diabetes is a major new development in the commercial landscape for insulin. Inhaled insulin technology requires up to 10 times the amount of insulin as injected insulin. This new technology, together with earlier diagnosis and increased incidence, is expected to quadruple the demand for insulin over the next five-year period. Our plant-produced insulin represents an enabling technology to meet this increased demand by reducing capital costs by up to 70% and reducing product costs by up to 40%. In 2005, we demonstrated increased levels of insulin expression in our model plant system, Arabidopsis, and we published preclinical results of plant-produced insulin from Arabidopsis in the Plant Biotechnology Journal, subsequent to the end of the year. Our next major insulin milestone is achieving commercial levels of expression in safflower in 2006.

We are entering 2006 with significant momentum due to our product development and commercial progress in 2005. This success is highlighted by the launch of our first commercial product DermaSphere®, our progress to increase expression levels of insulin in safflower and the successful $15.5 million financing we completed in December. A number of critical milestones are approaching in 2006 that will further demonstrate the viability of our platform to produce high value proteins and products, in particular, results of the commercial level of expression of insulin in safflower and targeted expression levels of DHA in Arabidopsis.

We believe that by setting clear milestones and surpassing them we demonstrate the execution that drives value creation. We look forward to updating you next quarter as we continue to realize the vision of SemBioSys to the benefit of its customers, shareholders, partners and employees.



Andrew Baum
President & CEO
SemBioSys Genetics Inc.
March 2006



IMMUNOSPHERE™

SemBioSys is developing ImmunoSphere™ with Aqua Bounty Technologies Inc. to target the US$2.5 billion annual shrimp feed market. ImmunoSphere™ is an immunostimulatory protein feed additive with the potential to protect shrimp from viral diseases like white spot disease. Viral disease has a devastating impact on aquaculture shrimp production. A recent outbreak of white spot disease eliminated two-thirds of Ecuador's production, relegating it from the list of top five exporters of shrimp worldwide. Shrimp producers in Mexico have readily adopted a first generation product developed by Aqua Bounty. We believe ImmunoSphere™ will offer producers enhanced yield and production economics for substantially less cost. SemBioSys is currently scaling up seed production in Chile and North America and initial product commercialization is anticipated for 2007, subject to regulatory approvals.

ANIMAL VACCINE

SemBioSys has completed a feasibility study to evaluate the utility of the Stratosome™ Biologics System for production of an experimental animal vaccine. SemBioSys established the applicability of its technology to produce plant-derived proteins for use in the manufacture of animal vaccines. The collaborative research project, with Dow AgroSciences LLC, applied the Stratosome™ Biologics System for the production, purification and formulation of an animal vaccine. The study demonstrates two important aspects of the Stratosome™ Biologics System – its flexibility to generate simple or complex proteins, such as a vaccine antigen, and its ability to cost-effectively address protein recovery and purification simultaneous with bulk protein production.

ANIMAL AND AQUACULTURE HEALTH PRODUCTS

DHA

Docosahexaenoic acid (DHA), an omega-3 fatty acid, is an important nutrient with proven health benefits as recognized by the 2005 Dietary Guidelines for Americans. DHA is gaining increased attention as new markets develop for nutritional oil food products. The trend to live and eat healthier by integrating healthier food and food-ingredients into our diet is driving the growth of the nutritional oil segment. Sales of essential fatty-acid supplements reached $440 million in 2004 with sales of plant-produced fatty acids growing by 27%. In the first nine months of 2005 alone, 244 new omega-containing food products were introduced into the US market.

SemBioSys has signed an exclusive, funded agreement with Martek Biosciences Corporation, the world's largest supplier of DHA, to develop DHA rich safflower oil to target these markets. In combination with Martek, SemBioSys is working to complete a proof-of-concept study in Arabidopsis during 2006.

GLA

Gamma linolenic acid (GLA), an omega-6 fatty acid, has a wide range of applications in the topical, medical food and nutrition markets.

Existing GLA supply from evening primrose and borage plants is expensive and unreliable. GLA rich safflower oil offers a scalable source of GLA at a much lower cost.

SemBioSys has completed its development milestones for the GLA agreement with Arcadia Biosciences, Inc. In particular, SemBioSys has demonstrated significant GLA accumulation in safflower. SemBioSys will receive ongoing royalties from Arcadia upon successful product commercialization, as well as license payments upon Arcadia's achievement of scale-up milestones.

NUTRITIONAL OILS

DERMASPHERE™

DermaSphere™, SemBioSys' first commercialized product, was launched in 2004 in partnership with Lonza Inc. under its Natrulan® brand of natural ingredients.

DermaSphere™ has a unique combination of formulation and functional properties and benefits that make it an ideal ingredient for the formulation of personal care products. These unique attributes allow DermaSphere® to be used in a wide range of personal care applications, including moisturizing creams, sunscreens, ointments, lotions and eye-care products. SemBioSys has received all license fee payments under the agreement and extends to receive its first royalty payment from Lonza in the first half of 2005.

The market for natural personal care products has experienced double digit growth for the last three years. Skincare is the leading segment within this category. Consumers are actively seeking new products that are milder, more natural and that offer improved moisturization and other benefits that are also cosmetically elegant.

STRATODERM™

StratoDerm™ uses the natural properties of oleosins for the application of topical small acids. The surfactant-free nature of oleosins and the ability to load oleosins with small active ingredients make them an ideal base for over-the-counter or prescription topical products. SemBioSys is pursuing partners with the appropriate technical and marketing profile to commercialize StratoDerm™.

TOPICAL INGREDIENTS

In 2004, 4,000 kg or US$4.3 billion worth of insulin was sold.

As the incidence of diabetes explodes and inhaled insulin becomes broadly available, the demand for insulin is projected to grow to 16,000 kg in 2010.

Who is going to make it all?

PHARMACEUTICAL

INSULIN

SemBioSys is developing safflower as a new source of insulin. This new plant source will offer unparalleled flexibility as well as superior economics compared to current fermentation-based production systems. While the cost of insulin is not an issue today in the western world, new alternative insulin delivery methods represent a disruptive technology to the market. Pfizer's new Exubera® inhaled insulin delivery technology was approved in the US and Europe. Inhalation requires up to 10 times more insulin per dose than injection. The combination of inhaled insulin, the increasing incidence of diabetes due to dietary attitudes and the earlier diagnosis of the disease will cause demand for insulin to quadruple in the next 5 years.

SemBioSys believes that plant-produced insulin can reduce capital costs by 70% and product costs by 40%. SemBioSys has produced commercial levels of insulin in its model plant system, Arabidopsis, and demonstrated its functional equivalence and bioavailability.

SemBioSys is currently working to achieve commercial levels of insulin expression in safflower, its commercial plant system.

Commercial expression is an important technical milestone. Because of the relative simplicity of the insulin protein and the extensive clinical data concerning insulin safety and efficacy, SemBioSys expects that regulatory approval will be based on abbreviated clinical trial protocols provided that safflower-produced insulin is sufficiently pure and bio-equivalent to commercial insulin. If regulatory approval is based on abbreviated clinical trial protocols (505(b)(2)), SemBioSys expects that its insulin product candidate could reach the market as early as 2009 or 2010.

PHARMACEUTICAL

APO AI

Apolipoprotein AI is a critical component of the natural cholesterol reverse transport pathway. Current cholesterol therapies, like statins, slow the buildup of plaque in the arteries that cause atherosclerosis. Apo AI therapy is the first treatment to demonstrate the reversal of plaque buildup in the arteries in clinical trials.

SemBioSys is developing plant-produced Apo AI. The successful Apo AI clinical trials required a very high dose of protein compared to other therapies, meaning that very high volumes of protein will be needed for successful commercialization of Apo AI. SemBioSys believes that safflower-produced Apo AI will allow us to cost effectively meet that level of demand.

SemBioSys has produced commercial levels of Apo AI in its model plant system, Arabidopsis, and demonstrated that plant produced Apo AI maintains the same size and physico-chemical characteristics of native Apo AI. SemBioSys is currently working to achieve commercial levels of Apo AI expression in safflower, its commercial plant system. Once SemBioSys has completed preclinical trials of plant produced Apo AI, it will pursue partnership opportunities with companies that have a recognized cardiovascular franchise.

PRODUCT PIPELINE

	MILESTONE EVENT
INSULIN DEMAND TO QUADRUPLE IN FIVE YEARS	Commercial levels of expression in safflower
APO AI A NEW CARDIOVASCULAR DRUG REQUIRING AN ENABLING PRODUCTION TECHNOLOGY	Commercial levels of expression in safflower
DERMASPHERE® FIRST COMMERCIALIZED PRODUCT	First royalties from Lonza
IMMUNOSPHERE™ SHRIMP PRODUCERS ALREADY ADOPTING FIRST GENERATION PRODUCT	Scale-up of product in Chile and North America
GLA HIGH YIELD RELIABLE SUPPLY	Arcadia to continue scale-up production
STRATODERM™ NATURAL SKIN CARE SYSTEM WITH DELIVERY CAPABILITIES	Commercial product by 2008
DHA HEALTHY LIVING IS DRIVING CONSUMER INTEREST AND DEMAND FOR OMEGA-3 OILS	Proof-of-concept milestone
ANIMAL VACCINES PLANT-DERIVED PROTEINS FOR USE IN VACCINE MANUFACTURING	Completed feasibility agreement for Dow AgroSciences

2006
COMMERCIAL PRODUCT
Q1
Q2
Q3
Q4
(Full-Year)

FINANCIAL REVIEW

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MANAGEMENT'S DISCUSSION & ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

For the years ended December 31, 2005 and 2004

This management discussion and analysis reflects SemBioSys Genetics Inc.'s ("SemBioSys" or the "Company") situation as of March 13, 2006. The following information should be read in conjunction with SemBioSys' audited consolidated financial statements and related notes for the year ended December 31, 2005 which were prepared in accordance with Canadian generally accepted accounting principles. Additional information relating to the Company, including our annual progress report and Annual Information Form for the year ending December 31, 2005, is available by accessing the SEDAR website at www.sedar.com.

FORWARD-LOOKING FINANCIAL STATEMENTS AND CAUTIONARY FACTORS THAT MAY AFFECT FUTURE RESULTS

Certain information contained in management's discussion and analysis of our financial condition and results of our operations constitute forward-looking statements which reflect Management's expectations regarding the Company's growth, results in operations, performance and business prospects and opportunities. Statements about the Company's future plans and intentions, results, levels of activity, performance or achievements or other future events constitute forward-looking statements. Whenever possible, words such as "anticipate", "estimate", "may", "will", "should", "could", "expect", "plan", "intend", "believe", "estimate", or "potential" or similar words, have been used to identify these forward-looking statements.

Forward-looking statements involve significant risk, uncertainties and assumptions. Many factors could cause actual results to differ materially from the results discussed or implied in the forward-looking statements. These factors should be considered carefully and readers should not place undue reliance on the forward-looking statements. Such risks and uncertainties include, among others, the need for and availability of funds and resources to pursue research and development projects, the efficacy of the Company's biopharmaceuticals as treatments for diabetes and cardiovascular disease, the success and timely completion of clinical studies and trials, the Company's ability to successfully commercialize its biopharmaceuticals and non-pharmaceutical products, uncertainties related to the research and development of biopharmaceuticals, uncertainties related to competition, changes in technology, the regulatory process and general changes to the economic environment.

Overview

SemBioSys Genetics Inc. is a biotechnology company focused on the development, commercialization and production of biopharmaceuticals and non-pharmaceutical products based on our plant genetic engineering skills and our proprietary oilbody-oleosin technology platform — the Stratosome™ Biologics System.

Business Plan

The Company's business strategy is to develop products which respond to a significant market need where its technology creates a sustainable competitive advantage. The primary focus is the development of biopharmaceuticals for metabolic and cardiovascular diseases. The Company is currently developing insulin (for diabetes) and Apo AI (for cardiovascular disease) product candidates. In addition to biopharmaceuticals, the Company has a number of non-pharmaceutical products under development addressing animal health, nutritional oil markets and human topical markets. Beyond generating revenue and profits in the short and medium term, these non-pharmaceutical products will allow us to develop much of the infrastructure required to commercialize our primary products.

The Company expects longer-term revenues and profits to be generated from the commercialization of biopharmaceuticals. The long time horizon for these products reflects the significant lead times required for clinical trials and regulatory approvals.

Business Model

Revenue is generated from licensing fees, contract research and related milestone payments and royalties. License fee revenue is derived from collaborative licensing arrangements for use of the Company's technology. Contract research revenue with contingent milestone payments are earned from collaborative research agreements that involve a scientific work plan which also generally include payments for achievement of specified milestones. Royalty revenue will be received from partner commercialization of the Company's licensed technology.

Expenses are classified into six categories; research and development, general and administration, intellectual property, business development, stock-based compensation and amortization. Research and development expenses consist primarily of personnel and related costs associated with the development of our portfolio of biopharmaceuticals and non-pharmaceutical products. General and administration costs consist of personnel and related costs associated with our administrative and finance functions as well as professional fees, office rent and utilities, insurance and other public company expenses including filing fees, investor relations and corporate governance. Intellectual property costs consist of personnel and related costs associated with the development and maintenance of our intellectual property portfolio as well as annual license fees. Our technology is protected by patents filed in all significant worldwide markets. Business development costs consist of personnel and related costs associated with promoting our products, technology platform and costs associated with contract research and partnering activities. Stock-based compensation expense consists of the estimated fair value of options granted to employees during the year. Amortization expense is based on the estimated useful life of our assets.

Expenses are partially offset by cost recoveries and investment tax credits. Cost recoveries consist of contributions from various government programs and third parties relating to the achievement of specific milestones. Investment tax credits consist of credits the Company is entitled to receive based on certain scientific research and experimental development expenditures.

Critical Accounting Policies and Estimates

The preparation of consolidated financial statements in accordance with Canadian generally accepted accounting principles requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results can differ from Management's best estimates and assumptions as additional information becomes available. Areas of significant estimates include the recognition of revenue, the useful life and impairment of property and equipment, and the valuation of stock-based compensation and warrants.

The significant accounting policies the Company believes are the most critical to aid in fully understanding and evaluating its reported financial results include the following:

Revenue Recognition

Licensing fee revenues from arrangements which require no future significant involvement or obligation to perform under the arrangement are recognized at the date the license is granted, if there is persuasive evidence of an arrangement, collection of the resulting receivable is reasonably assured, the fee is fixed or determinable, delivery has occurred and the contract has commenced. Similarly, non-refundable milestone payments are recognized upon the achievement of specified milestones when the milestone payment is substantive in nature, the achievement of the milestone was not reasonably assured at the inception of the agreement and the Company has no further significant involvement or obligation to perform under the arrangement.

Licensing fee revenues (initial fees and milestone payments) derived from collaborative licensing arrangements which require the ongoing involvement of the Company are deferred and amortized into income on a straight-line basis over the expected period of the ongoing involvement of the Company.

Contract research revenues for cost plus margin arrangements are recognized as the services are performed. Upfront payments under these arrangements are deferred and revenue is recognized over the life of the contract. Contract research revenues related to milestone agreements are recorded as milestones are achieved and customer acceptance has occurred.

Future royalty revenues, based on a percentage of sales of certain declared products sold by third parties, will be recorded when the Company has fulfilled the terms in accordance with the contractual agreement, has no future obligations, the amount of the royalty fee is determinable and collection is reasonably assured.

Research and Development

Research costs are expensed as incurred. Development costs that meet specific criteria for deferral under Canadian generally accepted accounting principles will be capitalized. No development costs have been deferred to date.

Cost Recovery Agreements and Government Assistance

Cost recovery agreements relate to various government programs whereby we are contracted to complete research projects and are reimbursed for research costs related to the specified project. The contribution agreements have specific milestones that must be completed under the terms of the agreements. Upfront payments are deferred and recognized over the agreement term. Milestone payments are recognized when the milestones have been achieved.

Investment Tax Credits

The Company is entitled to investment tax credits ("ITCs") based on certain scientific research and experimental development costs incurred. Refundable cash credits were recognized in prior years when there was reasonable assurance of their recovery using the cost reduction method. ITCs are subject to assessment by the Canada Revenue Agency. Adjustments required, if any, are reflected in the year when such assessments are received. ITCs related to scientific research and development expenditures incurred after the completion of the public offering are no longer refundable and may only be used to reduce future income taxes payable, if any.

ITCs and other cost recoveries related to property and equipment are credited against the book value of property and equipment and the credit is released to income on a straight-line basis as a reduction of amortization expenses over the estimated useful lives of the relevant assets. The remaining balance is recorded as a reduction of scientific research and development expenses.

Stock-Based Compensation

Effective January 1, 2004, the Company retroactively adopted the Canadian Institute of Chartered Accountants standard for accounting for stock-based compensation. This standard requires the recognition of the value of equity instruments awarded to employees and non-employees in the financial statements as if the fair value method had been used at the date of grant. The Company calculates the fair value of stock options issued using the Black-Scholes option-pricing model with consideration of factors specific to the Company. For options granted to employees and directors, the fair value is recognized at the date of grant and is deferred and expensed over the period the options vest, with a corresponding increase to contributed surplus. For options granted to consultants, an expense is recognized as services are provided.

Corporate & Collaboration Partnerships

Lonza Inc.

In April 2004, SemBioSys granted an exclusive global right, in the personal care market, to Lonza Inc. ("Lonza") covering the license, production and sale of the DermaSphere® Oleosome Technology, subject to minimum royalties and other performance requirements. Pursuant to the agreement, Lonza is responsible for the commercial production, marketing and sale of the DermaSphere® Oleosome Technology. Lonza made upfront license payments and the Company is eligible for royalty payments based on Lonza product sales. Lonza launched its first DermaSphere®-based product (Natrulon® OSF) under its Natrulon® line of natural ingredients in Q4 2004.

In 2005, the Company received the second and final scheduled licence payment from Lonza, and shipped market development quantities of DermaSphere® to Lonza resulting in total revenue of $618,559. This quantity of material was provided in the interim while Lonza's toll manufacturer commissions its manufacturing plant.

Dow AgroSciences LLC

In April 2004, the Company entered into a feasibility agreement with Dow AgroSciences LLC ("Dow"). The Agreement involved a proof-of-concept program based on the production of an animal vaccine using the Company's Stratosome™ Biologics System. It included upfront and milestone payments.

In 2005, the Company successfully completed the feasibility agreement with Dow. As a result of the successful completion of the program, SemBioSys earned $184,000 of milestone payments from Dow for a total of $234,963 earned from this project in 2005 and $368,000 since its inception.

Arcadia Biosciences, Inc.

In May 2004, SemBioSys entered into a development and license agreement with Arcadia Biosciences, Inc. ("Arcadia"), a private agricultural biotechnology company based in Phoenix, Arizona. Under the terms of the agreement, the Company was responsible for the development of safflower lines containing gamma linolenic acid ("GLA") and granted Arcadia an exclusive licence under applicable technology to commercialize safflower-produced GLA rich oil. GLA is an essential fatty acid with the potential for use in the topical, medical food and nutritional oils markets. The agreement includes license fees, contract research payments, earned milestone payments and royalties on product sales by Arcadia.

The Company successfully completed key milestones in Q4 2005 for its partner Arcadia. Arcadia is now responsible for the ongoing development of GLA rich safflower oil and its commercialization in the topical, medical food and nutritional oil markets. Milestone payments of $587,324 were earned in 2005 for total payments amounting to US$635,000.

Martek Biosciences Corporation

In December 2003, the Company entered into an exclusive agreement with Martek Biosciences Corporation ("Martek") of Columbia, Maryland, the world's largest supplier of docosahexaenoic acid ("DHA"). Under the terms of the agreement, the Company is responsible for the development of safflower lines containing DHA and will grant Martek the exclusive rights to the research results in order to commercialize safflower-produced DHA rich oil. The Company is eligible to receive up to a total of US$10 million in contract research payments and milestone payments as well as royalties on Martek's gross margins and sublicense revenues.

During the year, the Company continued to complete research on the project and earned $718,381 in research payments from Martek.

Selected Annual Information ($ thousands, except per share amounts)

	2005 $	2004 $	2003 $
Revenues	2,459.2	1,467.9	4,949.5
Interest income	421.1	149.7	148.2
Net loss	(6,824.5)	(5,692.5)	(1,774.8)
Loss per share, basic and diluted	(0.54)	(0.95)	(0.33)
Total assets	34,638.9	23,667.2	14,037.2
Total long-term financial liabilities	1,877.3	430.0	1,521.1

Results Of Operations — Comparison of the years ended December 31, 2005 and 2004

Revenues

(in thousands of $)	Year ended December 31, 2005 $	Year ended December 31, 2004 $	Change $	Change %
License fees	763.0	343.1	419.9	122.4
Contract research	1,696.2	1,124.8	571.4	50.8
	2,459.2	1,467.9	991.3	67.5

License fees increased by $419,932 for year ended December 31, 2005, over the prior year ended December 31, 2004 as a result of recognition throughout the year of a portion of the upfront license fees from the Lonza, Arcadia and CytoStore Inc. technology license agreements in accordance with the revenue recognition policy of the Company. There was no comparable revenue in the first quarter of 2004.

Contract research revenue increased by $571,402 in the year ended December 31, 2005, over the prior year ended December 31, 2004. The revenue for the current year relates to research performed by the Company with respect to collaboration agreements between Martek, Dow and Arcadia. The increase for the current year is due to no Martek comparable revenue for a full year in 2004 with the Dow and Arcadia revenue only being earned beginning in April and May 2004, respectively. In addition, the successful completion of the Dow and Arcadia projects resulted in milestone payments being earned as noted earlier.

Expenditures

(in thousands of $)	Year ended December 31, 2005 $	Year ended December 31, 2004 $	Change $	Change %
Research and development	4,420.9	3,849.3	571.6	14.8
General and administration	3,516.9	2,901.2	615.7	21.2
Intellectual property	1,586.8	1,151.4	435.4	37.8
Business development	480.0	464.5	15.5	3.3
Stock-based compensation	131.3	—	131.3	100.0
Amortization	568.6	586.8	(18.2)	(3.1)
Cost recoveries	(899.0)	(921.1)	22.1	2.4
Investment tax credits	(71.3)	(846.5)	775.2	91.6
	9,734.2	7,185.6	2,548.6	35.5

Research and development ("R&D") costs increased by $571,594 in the year ended December 31, 2005, over the year ended December 31, 2004 primarily from increased salary expenses from added staff and normal salary increases, an enhanced quality control and assurance program and added field studies related to product development programs. The Company increased its R&D staff to begin preparation for pre-clinical and clinical trials related to Insulin and Apo AI and future pipeline candidates.

General and administration expenses increased by $615,710 in the year ended December 31, 2005, compared with the prior year ended December 31, 2004. The variance is due mainly to additional costs associated with being a publicly listed company including listing fees, investor relations, and corporate governance. In addition, the finance and accounting team was bolstered to accommodate these additional responsibilities.

Intellectual property costs increased by $435,344 in the year ended December 31, 2005, compared with the prior year, which is mainly attributable to the payment of an additional license fee in 2005 that was substantial. In addition there were several new patents that were filed in Q4 2005 as well as the related legal opinions surrounding these patents.

Business development costs were $15,500 higher in the year ended December 31, 2005, than in the year ended December 31, 2004. The small variance is mainly attributable to no longer having a US-based employee in 2005 and the costs related to this employee. This was partially offset with increased business and marketing activities as a result of more travel and conference activities as a result of a larger portfolio of products and increased activity in expanding the product pipeline.

Stock-based compensation costs increased by $131,384 in the year ended December 31, 2005 compared with the prior year due to the Company recording the fair value from the issuance of stock options to employees and directors in 2004 and 2005.

Amortization expense decreased by $18,172 in the year ended December 31, 2005, compared with the year ended December 31, 2004. This decline was due to certain property and equipment being fully amortized that more than offset the depreciation on new assets purchased in recent years.

Cost recoveries decreased by $22,131 in the year ended December 31, 2005, compared to the prior year as a result of the completion of the AVAC Antibody Project in the second quarter of 2004 and the expiration of a wage subsidy program during the year. Cost recoveries include payments from miscellaneous government assistance programs and from milestone payments under the AVAC Ltd. agreements.

Investment tax credits were $775,148 lower in the year ended December 31, 2005 than in the year ended December 31, 2004. ITCs related to scientific research and development expenditures incurred after the completion of the public offering (in the fourth quarter of 2004) are no longer refundable and may only be used to reduce future income taxes payable, if any. The current year amount of $71,308 relates to receipt of 2004 refundable ITCs in 2005 in excess of the amount accrued at the end of 2004.

Investment and Other Income (Expenses)

(in thousands of $)	Year ended December 31, 2005 $	Year ended December 31, 2004 $	Change $	Change %
Interest income	421.1	149.7	271.4	181.3
Interest expense	(31.4)	(166.7)	135.3	81.2
Foreign exchange gain	52.0	42.2	9.8	23.2
Gain on sale of asset	8.8	—	8.8	100.0
Total other income (expenses)	450.5	25.2	425.3	1,687.7

Interest income was $271,351 higher in the year ended December 31, 2005, than in the prior year as a result of a substantially higher average cash balance. This is from funds received in the fourth quarter of 2004 from the completion of the Company's Initial Public Offering and in the first quarter of 2005 from the exercise of the over-allotment granted to the Underwriters. In addition, in the fourth quarter of 2005 the Company executed the debt financing and private placement equity offering.

Interest expense decreased by $135,347 for the year ended December 31, 2005, compared with the year ended December 31, 2004, primarily as a result of no interest incurred on the Syngenta Participations AG ("Syngenta") promissory note in 2005. Syngenta exercised their option to convert the promissory note into common shares in the fourth quarter of 2004. Additionally, the Company continued to pay down existing long-term debt resulting in a reduction of interest expense. This was partially offset by the additional debt financing facility obtained and drawn on in late 2005.

The foreign exchange gain of $52,028 in 2005 primarily relates to the net positive impact of the changes in US dollar foreign exchange rate on accounts payable and long-term debt denominated in US dollars. The gain in 2004 is primarily related to the positive impact from the change in the US dollar foreign exchange rate related to the Syngenta US$2.25 million convertible promissory note.

Summary of Quarterly Financial Information ($ thousands, except per share amounts)

	2005				2004			
	Q4 $	Q3 $	Q2 $	Q1 $	Q4 $	Q3 $	Q2 $	Q1 $
Revenues	728.1	682.7	561.7	486.7	515.6	455.8	330.9	165.6
Interest income	115.8	90.4	102.3	112.6	37.7	22.2	36.5	53.3
Net loss	(2,025.3)	(1,845.2)	(1,558.1)	(1,395.9)	(1,414.9)	(1,288.7)	(1,448.5)	(1,540.4)
Loss per share, basic and diluted	(0.16)	(0.15)	(0.12)	(0.11)	(0.16)	(0.24)	(0.27)	(0.28)

The Company's revenue continued to grow throughout each of the quarters in 2005 with the exception of a small decline from Q4 2004 to Q1 2005. The revenue growth is due to the maturity of the Company's collaborative projects as listed previously, as well as successfully completing milestones on most of these projects. Interest income increased significantly from the end of 2004 to the beginning of 2005 from the successful completion of the Company's Initial Public Offering in which $17.5 million was raised in Q4 2004 and the over-allotment of $2.6 million in Q1 2005. The decline in interest income for Q2 and Q3 is a result of the Company's net cash burn. In Q4 2005, the Company completed a $15.5 million Private Placement resulting in increased interest income in that quarter. However, the Company's net loss increased during each of the quarters in 2005 as a result of the Company's continued expansion of the team to facilitate execution of the workload for each of its projects as well as to build further clinical expertise as the biopharmaceutical products begin to move closer to the clinic.

Liquidity and Capital Resources

(in thousands of $)	Year ended December 31, 2005 $	Year ended December 31, 2004 $	Change $	Change %
Cash used in operating activities	(7,318.2)	(5,269.2)	(2,049.0)	(38.9)
Cash provided by financing activities	18,435.6	15,133.3	3,302.3	21.8
Cash used in investing activities	(1,440.7)	(470.8)	(969.9)	(206.0)
Increase in cash and cash equivalents	9,676.7	9,393.3	283.4	3.0

Our primary capital needs are for funds to support our scientific research and development activities including pre-clinical and clinical trials and capital expenditures for development of cGMP facilities, lab equipment and working capital. Since inception, the Company has financed its cash requirements primarily through issuances of securities, investment tax credits, government funding, cost recoveries, contract research revenues, long-term debt and interest income.

Our investment activities are subject to the guidelines contained in our investment policy. We invest only in liquid, high-grade investment securities of reputable banks.

At December 31, 2005, the Company had cash and cash equivalents of $28.5 million and a net positive working capital balance of $28.1 million. Long-term debt at year end was $1.3 million.

Operating Activities

For the year ended December 31, 2005, in comparison to the prior year, cash used in operating activities increased by $2,049,103, mainly as a result of an increased loss for the year and an increase in non-cash working capital. The increased loss is explained in more detail in the results of operations analysis as documented earlier. The increase in non-cash working capital is primarily due to recognition of deferred revenue and cost recoveries.

Financing Activities

Cash provided by financing activities of $18,435,626 was primarily a result of the three financing activities in 2005: the over-allotment related to the Initial Public Offering of $2,429,387, debt financing of $1,658,122 and $14,458,582 from completion of the private placement offering, all net of issue costs.

With respect to the Prospectus dated November 24, 2004 and the public offering completed as at December 6, 2004, the Company granted to the Underwriters an over-allotment option, exercisable by the Underwriters at any time prior to 45 days from December 6, 2004, to purchase up to 525,000 common shares and 262,500 share purchase warrants at prices of $4.99 and $0.01, respectively. The over-allotment was exercised in full on January 7, 2005, for gross proceeds of $2,625,000.

In November 2005, SemBioSys executed $2,500,000 in new long-term secured debt financing from Oxford Finance Corporation of Virginia. The debt facility is being used to fund the Company's capital asset purchases, including increasing the capacity of the Company's plant growth facilities. The plant growth facility expansion is necessary to provide additional capacity for the ongoing scale-up of the Company's biopharmaceuticals. The funding is also being used to purchase the analytical equipment necessary to implement SemBioSys' clinical and pre-clinical programs. At December 31, 2005, $1.7 million of the facility has been utilized leaving $0.8 million available.

In December 2005, SemBioSys issued 3,864,000 units at a price of $4.00 per unit, for total proceeds of $15,456,000. Each unit consists of one common share and one-half of one common share purchase warrant. Each whole common

share purchase warrant entitles the holder to purchase one common share of SemBioSys at a price of $5.50 for a period of 30 months following the closing date of the offering. The issued shares are subject to a four-month hold period from the closing date.

As at December 31, 2005, the Company has not entered into any off-balance sheet arrangements or hedging arrangements.

Investing Activities

Investing activities during the year ended December 31, 2005 were $1,440,663. This included significant expansion of our in-house plant growth facility, lab equipment additions, IT equipment and infrastructure upgrades and initial cGMP facility design costs. In 2004, the Company had restricted its spending on capital equipment due to cash constraints and thus contributed to reduced capital asset expenditures in 2004 in comparison to 2005.

Contractual Obligations and Commitments

The Company has entered into operating leases for laboratory equipment, a corporate head office and a secondary facility ending in 2011 as well as for computers and furniture. The Company also has loans repayable until December 2009. The minimum payments for the next five years are as follows:

$ Thousands	Total	<1 year	1–3 years	4–5 years	>5 years
Lease commitments	2,860,882	494,754	1,003,232	984,694	378,202
Loans payable	1,877,330	590,243	1,041,523	245,564	—
Total	4,738,212	1,084,997	2,044,755	1,230,258	378,202

Risks And Uncertainties

General Risk Factors

Prospects for biotechnology companies in the research and development stage should generally be regarded as speculative. For our biopharmaceutical products, it is not possible to predict, based upon studies in animals, or early studies in humans, whether a new therapeutic will ultimately prove to be safe and effective in humans, or whether necessary and sufficient data can be developed through the clinical trial process to support a successful product application and approval.

If a product is approved for sale, product manufacturing at a commercial scale and significant sales to end users at a commercially reasonable price may not be successful. There can be no assurance that the Company will generate adequate funds to continue development, or will ever achieve significant revenues or profitable operations. Many factors (e.g. competition, patent protection, appropriate regulatory approvals) can influence the revenue and product profitability potential.

In developing a product for approval, the Company will rely upon its employees, contractors, consultants and collaborators and other third party relationships, including the ability to obtain appropriate product liability insurance. There can be no assurance that these reliances and relationships will continue as required.

Risk Factors Affecting Future Performance

To achieve profitable operations the Company, alone or with others, must successfully develop, introduce and market its products. To obtain regulatory approvals for products being developed for human use, and to achieve commercial success, human clinical trials must demonstrate that the product is safe for human use and that the product shows efficacy. Unsatisfactory results obtained from a particular study relating to a program may cause the

Company to abandon its commitment to that program or the product being tested. No assurances can be provided that any current or future animal or human test, if undertaken, will yield favourable results. If the Company is unable to establish that one of their products is a safe, effective treatment for target, it may be required to abandon further development of the product and develop a new business strategy.

There are inherent risks in research and development.

Research and development is highly speculative and involves a high and significant degree of risk. The marketability of any product developed by the Company will be affected by numerous factors beyond the Company's control, including:

- Manufacturing costs or other factors may make manufacturing of products impractical and non-competitive;
- Proprietary rights of third parties or competing products or technologies may preclude commercialization;
- Requisite regulatory approvals for the commercial distribution of products may not be obtained; and
- Other factors may become apparent during the course of research, up-scaling or manufacturing which may result in the discontinuation of research and other critical projects.

The Company's biopharmaceutical products under development have never been manufactured on a commercial scale, and there can be no assurance that such products can be manufactured at a cost or in a quantity to render such products commercially viable. Production and utilization of the Company's products may require the development of new manufacturing technologies and expertise. The impact on the Company's business in the event that new manufacturing technologies and expertise are required to be developed is uncertain. There can be no assurance that the Company will successfully meet any of these technological challenges, or others that may arise in the course of development.

The Company's operations and products may be subject to other government manufacturing and testing regulations.

Securing regulatory approval for the marketing of biopharmaceuticals and non-pharmaceutical products by the regulatory bodies in Canada and the United States and similar regulatory agencies in other countries is a long and expensive process, which can delay or prevent product development and marketing. Approval to market products may be for limited applications or may not be received at all.

In addition to the regulatory approval process, the Company may be subject to regulations under local, provincial, state, federal and foreign law, including requirements regarding occupational health, safety, laboratory practices, environmental protection and hazardous substance control, and may be subject to other present and future local, provincial, state, federal and foreign regulations.

The Company's technologies may become obsolete.

The biotechnology industry is characterized by rapidly changing markets, technology, emerging industry standards and frequent introduction of new products. The introduction of new products embodying new technologies, including new manufacturing processes, and the emergence of new industry standards may render the Company's products obsolete, less competitive or less marketable. The process of developing the Company's products is extremely complex and requires significant continuing development efforts and third party commitments. The Company's failure to develop new technologies and products and the obsolescence of existing technologies could adversely affect its business.

The Company may be unable to anticipate changes in its potential customer requirements that could make the Company's existing technology obsolete. The Company's success will depend, in part, on its ability to continue to enhance its existing technologies, develop new technology that addresses the increasing sophistication and varied needs of the market, and respond to technological advances and emerging industry standards and practices on a timely and cost-effective basis. The development of the Company's proprietary technology entails significant technical and business risks. The Company may not be successful in using its new technologies or exploiting its niche markets effectively or adapting its businesses to evolving customer or medical requirements or preferences or emerging industry standards.

The Company has a history of losses.

To date, the Company has not generated sufficient revenues to offset its research and development costs and accordingly has not generated positive cash flow or made an operating profit. As of December 31, 2005, the Company had an accumulated deficit of $26.6 million. The Company incurred net losses of $6.8 million, $5.7 million, and $1.8 million for the years ended December 31, 2005, 2004, and 2003, respectively. The Company anticipates that it will continue to incur significant losses during 2006 and in the foreseeable future. The Company will not reach profitability until after successful and profitable commercialization of one or more of its products. Even if one or more of its products are profitably commercialized, the initial losses incurred by the Company may never be recovered.

The Company may need additional financing in the future to fund the research and development of its products and to meet its ongoing capital requirements.

As of December 31, 2005, the Company had cash and cash equivalents of $28.5 million and working capital of approximately $28.1 million. The Company anticipates that it may need additional financing in the future to fund research and development and to meet its ongoing capital requirements. The amount of future capital requirements will depend on many factors, including continued scientific progress in its drug discovery and development programs, progress in its pre-clinical and clinical evaluation of drug candidates, time and expense associated with filing, prosecuting and enforcing its patent claims and costs associated with obtaining regulatory approvals. In order to meet such capital requirements, the Company will consider contract fees, collaborative research and development arrangements, and additional public or private financings (including the incurrence of debt and the issuance of additional equity securities) to fund all or a part of particular programs as well as potential partnering or licensing opportunities. There can be no assurance that additional funding will be available or, if available, that it will be available on acceptable terms. If adequate funds are not available on terms favourable to the Company, the Company may have to reduce substantially or eliminate expenditures for research and development, testing, production and marketing of its proposed product, or obtain funds through arrangements with corporate partners that require the Company to relinquish rights to certain of its technologies or products. There can be no assurance that the Company will be able to raise additional capital if its current capital resources are exhausted.

The Company incurs some of its expenses in foreign currencies and therefore is exposed to foreign currency exchange rate fluctuations.

The Company incurs some of its expenditures and receives certain revenue in US dollars. In addition, the Company's debt facility is denominated in US dollars. Over the past year the Canadian dollar has appreciated relative to the US dollar thereby decreasing the Canadian dollar equivalent. However, if this trend reverses, the Company's Canadian dollar equivalent costs will increase.

Also, as the Company expands to other foreign jurisdictions there may be an increase in its foreign exchange exposure.

The Company earns interest income on its excess cash reserves and is exposed to changes in interest rates.

The Company invests its excess cash reserves in investment vehicles that provide a rate of return with little risk to principle. As interest rates change the amount of interest income the Company earns will be directly impacted.

Additional risks and uncertainties relating to the Company can be found in our Annual Information Form for the year ending December 31, 2005.

Transactions with Related Parties

Dow AgroSciences LLC is considered a related party as a result of its subsidiary's (Dow AgroSciences Canada Inc.) equity investment in the Company. During the year, the Company earned $234,963 from its research collaborative agreement with Dow AgroSciences LLC as described previously. In addition, technical assistance provided by Dow AgroSciences LLC in prior years resulted in an amount due to Dow of $nil at December 31, 2005 and $129,369 at December 31, 2004.

UTI Limited Partnership ("UTI") is considered a related party as a result of its equity investment in the Company. During the year, the Company accrued $25,000 (December 21, 2004 – $25,000) payable to UTI for a minimum fee related to licensed technology.

Financial Instruments and Other Instruments

The Company does not use financial derivatives or "other financial instruments".

Proposed Transactions

There are no proposed asset or business acquisition or disposition transactions pending as at December 31, 2005.

Other MD&A Requirements

The Company has 16,565,400 common shares outstanding at March 13, 2006. If all of the Company's options and warrants were exercised, the Company would have 22,049,405 common shares outstanding.

The Company has designed disclosure controls and procedures to provide reasonable assurance that material information related to the Company is included in the Company's annual filings. In addition, the Company has evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the filing period of December 31, 2005 and concluded that these controls are effective.

MANAGEMENT'S STATEMENT OF RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and have been approved by the Board of Directors.

In support of this responsibility, management maintains a system of internal controls to provide reasonable assurance as to the reliability of financial information and the safeguarding of assets. The consolidated financial statements include amounts which are based on the best estimates and judgments of management.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls. The Board of Directors exercises this responsibility principally though the Audit Committee. The Audit Committee consists of independent directors not involved in the daily operations of the Company. The Audit Committee meets with management and the external auditors to satisfy itself that management's responsibilities are properly discharged and to review the consolidated financial statements prior to their presentation to the Board of Directors for approval.

The external auditors, PricewaterhouseCoopers LLP, appointed by the shareholders of the Company, have examined the financial statements and have expressed an opinion on the statements. The external auditors have free and full access to the Audit Committee with respect to their findings concerning the fairness of financial reporting and the adequacy of internal controls. Their report is included with the consolidated financial statements.

Andrew Baum
President & CEO

James Szarko, CA
Chief Financial Officer

AUDITORS' REPORT

To the Shareholders of SemBioSys Genetics Inc.

We have audited the consolidated balance sheets of SemBioSys Genetics Inc. as at December 31, 2005 and 2004 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
Calgary, Alberta
February 17, 2006

CONSOLIDATED BALANCE SHEETS

As at December 31, 2005 and 2004

(expressed in Canadian dollars)

	2005 $	2004 $
ASSETS		
Current assets		
Cash and cash equivalents	28,513,095	18,836,396
Accounts receivable	1,363,541	458,995
Investment tax credits receivable	–	750,000
Prepaid expenses, deposits and other	265,062	99,739
	30,141,698	20,145,130
Property and equipment *(note 3)*	4,497,190	3,522,102
	34,638,888	23,667,232
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities *(note 4)*	1,368,276	902,617
Repayable advances	85,640	275,822
Current portion of long-term debt *(note 6)*	590,243	173,683
	2,044,159	1,352,122
Deferred cost recoveries *(note 5)*	76,535	354,062
Deferred revenue	195,259	906,759
Long-term debt *(note 6)*	1,287,087	256,326
	3,603,040	2,869,269
SHAREHOLDERS' EQUITY		
Capital stock *(note 9)*	48,103,709	35,619,699
Contributed surplus *(note 9)*	131,384	–
Warrants *(note 9)*	9,414,155	4,967,119
Deficit	(26,613,400)	(19,788,855)
	31,035,848	20,797,963
	34,638,888	23,667,232

Contingencies and commitments *(notes 4, 5, 7 and 11)*

The accompanying notes are an integral part of these consolidated financial statements.

Approved by the Board of Directors

Richard Smith, Chairman & Director

David Howard, Director

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

For the years ended December 31, 2005 and 2004

(expressed in Canadian dollars)

	2005 $	2004 $
REVENUE		
Licensing fees *(note 7)*	763,031	343,099
Contract research *(notes 4 and 7)*	1,696,171	1,124,769
	2,459,202	1,467,868
EXPENSES		
Research and development	4,420,886	3,849,292
General and administration	3,516,871	2,901,161
Intellectual property costs *(note 4)*	1,586,788	1,151,444
Business development	480,022	464,522
Stock-based compensation	131,384	–
Amortization	568,595	586,767
Cost recoveries *(note 5)*	(899,018)	(921,149)
Investment tax credits	(71,308)	(846,456)
	9,734,220	7,185,581
Loss before the undernoted	(7,275,018)	(5,717,713)
Interest income	421,091	149,740
Interest expense	(31,410)	(166,757)
Foreign exchange gain	52,028	42,237
Gain on sale of property and equipment	8,764	–
	450,473	25,220
Net loss for the year	(6,824,545)	(5,692,493)
Deficit – Beginning of year	(19,788,855)	(14,096,362)
Deficit – End of year	(26,613,400)	(19,788,855)
Loss per share – basic and diluted	(0.54)	(0.95)

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31, 2005 and 2004

(expressed in Canadian dollars)

	2005 $	2004 $
Cash provided by (used in)		
Operating activities		
Net loss for the year	(6,824,545)	(5,692,493)
Add items not affecting cash		
Amortization	568,595	586,766
Accretion of convertible promissory note	–	124,117
Gain on sale of property and equipment	(8,764)	–
Stock-based compensation	131,384	–
Unrealized foreign exchange gain	(36,975)	(133,279)
	(6,170,305)	(5,114,889)
Change in non-cash working capital and other balances related to operations	(1,147,959)	(154,272)
	(7,318,264)	(5,269,161)
Financing activities		
Issuance of units	18,081,000	17,500,000
Share issue costs	(1,193,031)	(2,294,022)
Exercise of stock options	63,361	42,228
Proceeds from long-term debt	1,658,122	–
Repayment of long-term debt	(173,826)	(114,886)
	(18,435,626)	15,133,320
Investing activities		
Proceeds on sale of property and equipment	12,300	–
Acquisition of property and equipment	(1,452,963)	(470,803)
	(1,440,663)	(470,803)
Increase in cash and cash equivalents	9,676,699	9,393,356
Cash and cash equivalents – Beginning of year	18,836,396	9,443,040
Cash and cash equivalents – End of year	28,513,095	18,836,396
Supplemental information		
Cash interest received	341,510	149,740
Cash interest paid	16,802	34,341
Non-cash transactions		
Settlement of convertible note payable for common shares *(note 8)*	–	2,918,208
Share issue costs included in accounts payable	20,284	165,665
Capital items included in accounts payable	94,256	10,180

The accompanying notes are an integral part of these consolidated financial statements.

1 Nature of operations

SemBioSys Genetics Inc. ("the Company") is a biotechnology company, which was incorporated on April 25, 1994. The Company is focused on the development, commercialization and production of biopharmaceuticals and non-pharmaceutical products based on its plant genetic engineering skills and its proprietary oleosin-oilbody technology platform. At its current stage of development, the Company derives its revenues from licensing fees and contract research for and in collaboration with third parties.

2 Significant accounting policies

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. The following is a summary of significant accounting policies.

Basis of consolidation

These consolidated financial statements include the accounts of the Company and its United States subsidiary, SemBioSys, Inc.

Revenue recognition

Licensing fee revenues from arrangements which require no future significant involvement or obligation to perform under the arrangement, are recognized at the date the license is granted, if there is persuasive evidence of an arrangement, collection of the resulting receivable is reasonably assured, the fee is fixed or determinable, delivery has occurred and the contract has commenced. Similarly, non-refundable milestone payments are recognized upon the achievement of specified milestones when the milestone payment is substantive in nature, the achievement of the milestone was not reasonably assured at the inception of the agreement and the Company has no further significant involvement or obligation to perform under the arrangement.

Licensing fee revenues (initial fees and milestone payments) derived from collaborative licensing arrangements which require the ongoing involvement of the Company are deferred and amortized into income on a straight-line basis over the expected period of the ongoing involvement of the Company.

Contract research revenues for cost plus margin arrangements are recognized as the services are performed. Upfront payments under these arrangements are deferred and revenue is recognized over the life of the contract. Contract research revenues related to milestone agreements are recorded as milestones are achieved and customer acceptance has occurred.

Future royalty revenues, based on a percentage of sales of certain declared products sold by third parties, will be recorded when the Company has fulfilled the terms in accordance with the contractual agreement, has no future obligations, the amount of the royalty fee is determinable and collection is reasonably assured.

Cost recovery agreements and government assistance

The contribution agreements (note 5) have specific milestones that must be completed under the terms of the agreements. Upfront payments are deferred and recognized over the agreement term. Milestone payments are recognized when the milestones have been achieved.

Property and equipment

Property and equipment are recorded at cost less accumulated amortization. Amortization of property and equipment is provided over their estimated useful lives, on a straight-line basis at the following annual rates:

Leasehold improvements	10 years or lease term
Laboratory equipment	10 years
Process development equipment	10 years
Other equipment	3–5 years

Management assesses the carrying amount of property and equipment for impairment annually and an impairment loss is recognized when the carrying amount exceeds future cash flows. No impairment loss has been recorded to date.

Investment tax credits

The Company is entitled to investment tax credits ("ITCs") based on certain research and experimental development costs incurred. Refundable cash credits were credits recognized in prior years when there was reasonable assurance of their recovery using the cost reduction method. ITCs are subject to assessment and approval by the Canada Revenue Agency. Adjustments required, if any, are reflected in the year when such assessments are received. ITCs relating to scientific research and development expenditures incurred after the completion of the public offering are no longer refundable and may only be used to reduce future income taxes payable, if any.

Investment tax credits and other cost recoveries related to property and equipment are credited against the book value of property and equipment and the credit is released to income on a straight-line basis as a reduction of amortization expenses over the above-noted estimated useful lives of the relevant assets. The remaining balance is recorded as a reduction of scientific research and development expenses.

Research and development costs

Research costs are expensed as incurred. Development costs that meet specific criteria for deferral under Canadian generally accepted accounting principles will be capitalized. No development costs have been deferred to date.

Intellectual property costs

Intellectual property costs include patent costs and other costs such as legal opinions, licensing fees and royalties. These costs are expensed as incurred.

Cash and cash equivalents

Cash and cash equivalents consists of cash on deposit and demand term deposits. Cash and demand short-term deposits are held with highly rated financial institutions.

Stock-based compensation

Effective January 1, 2004, the Company retroactively adopted the Canadian Institute of Chartered Accountants standard for accounting for stock-based compensation. This standard requires the recognition of the value of equity instruments awarded to employees and non-employees in the financial statements as if the fair value method had been used at the date of grant. The Company calculates the value of stock options issued using the Black-Scholes option pricing model with consideration of factors specific to the Company. For options granted to employees and directors, the value is recognized at the date of grant and is deferred and expensed over the period the options vest, with a corresponding increase to contributed surplus. For options granted to consultants, an expense is recognized as services are provided.

Loss per common share

Loss per share is calculated using the weighted average number of common shares outstanding during the year. The Company uses the treasury method of calculating diluted loss per common share. Under this method, diluted loss per share is computed in a manner consistent with basic loss per share except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of options and warrants, if dilutive. The number of additional shares is calculated by assuming that any outstanding "in the money" options and warrants were exercised at the later of the beginning of the period or the date of issue and that the proceeds from such exercises were used to acquire shares of common stock at the average market price during the reporting period.

Income taxes

The Company uses the liability method of accounting for income taxes under which future tax assets and liabilities are recognized for differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using substantively enacted tax rates in effect in the period in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized as part of the provision for income taxes in the period that includes the substantive enactment date. A valuation allowance is recorded against the future tax asset to the extent it is more likely than not that some or all of the future tax asset will not be realized.

Foreign currency translation

Transactions denominated in foreign currencies and the financial statements of the integrated foreign operations are translated into Canadian dollars using the temporal method. Under this method, monetary assets and liabilities are translated using the rate of exchange in effect at the balance sheet date, whereas other non-monetary assets and liabilities are translated at the rate of exchange in effect on the date of the transaction. Revenues and expenses are remeasured at monthly average rates prevailing throughout the period, except for amortization which is remeasured at exchange rates prevailing when the related assets were acquired. Exchange gains and losses resulting from translation are included in the statement of operations.

Use of estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from management's best estimates as additional information becomes available. Significant estimates are made for the determination of recognized revenue, the useful life and impairment of property and equipment and the valuation of stock-based compensation and warrants.

Comparative figures

Certain comparative figures have been reclassified to conform with the current year financial statements presentation.

3 Property and equipment

	2005		
	Cost $	Accumulated amortization $	Net $
Laboratory equipment	2,413,198	989,191	1,442,007
Leasehold improvements	2,981,797	1,508,910	1,472,887
Process development equipment	1,263,332	524,566	738,766
Other equipment	2,354,348	720,176	1,634,172
Less: Investment tax credits	(326,000)	(143,058)	(182,942)
Government assistance	(1,149,976)	(542,276)	(607,700)
	7,554,699	3,057,509	4,497,190

	2004		
	Cost $	Accumulated amortization $	Net $
Laboratory equipment	2,215,181	754,464	1,460,717
Leasehold improvements	2,981,797	1,295,124	1,686,673
Process development equipment	1,200,581	396,117	804,464
Other equipment	1,095,005	586,515	508,490
Less: Investment tax credits	(326,000)	(110,458)	(215,542)
Government assistance	(1,149,976)	(427,276)	(722,700)
	6,016,588	2,494,486	3,522,102

4 Related party transactions

Dow AgroSciences Canada Inc. is considered a related party as a result of its equity investment in the Company and representation on the Company's Board of Directors. In May 2004, the Company entered into a feasibility agreement with Dow AgroSciences LLC, the parent of Dow AgroSciences Canada Inc., with milestone payments amounting to $368,000. The exchange amount for this contract research arrangement approximates the estimated fair value of the contract. During the year, the Company earned $234,963 (2004 – $59,437) which is recorded as contract research. In addition, technical assistance provided by Dow AgroSciences LLC in prior years resulted in an amount payable at December 31, 2004 of $129,369. The amount was unsecured, non-interest bearing and repayable on demand and was included in accounts payable. The full amount was repaid during the year.

UTI Limited Partnership ("UTI"), a wholly owned subsidiary of the University of Calgary, is considered a related party as a result of its equity investment in the Company and representation on the Company's Board of Directors. In March 1996, the Company entered into a technology licensing agreement with UTI. Under the terms of the agreement, UTI granted the Company the exclusive worldwide rights to the oilbody-oleosin technology and worldwide right to sublicense products produced using the oilbody-oleosin technology. In return, the Company is required to pay a minimum fee to UTI in the amount of $25,000 creditable to the royalties otherwise payable by SemBioSys. The amount payable at December 31, 2005 of $25,000 (2004 – $25,000) is included in accounts payable. The Company must also pay UTI royalties if the oilbody-oleosin technology covered by the license is used to commercialize products. Royalties will equal 2% of net sales of products produced using the oilbody-oleosin technology ("Licensed Products"). Royalties for Licensed Products for which there is no patent issued within seven years

of the first commercial sale of the product shall be reduced to 1% of Licensed Product net sales for the following five years. The Company must also pay to UTI one quarter of all royalties earned from sublicenses. As of December 31, 2005, no royalties have been recorded to date.

5 Cost recoveries

a) In March 2001, the Company entered into a repayable contribution agreement with Technology Partnerships Canada ("TPC"), an agency of the Government of Canada. As of December 31, 2005, the Company has received the maximum amount of $5,484,637 (2004 – $5,484,637). The contribution is repayable at a rate of 1.5% of gross revenues arising from commercialization of the technology developed by the Company. If, by December 31, 2010, the total cumulative royalty payments paid are equal to or exceed $16.7 million, the royalty period ends. If the total cumulative royalty payments made are less than $16.7 million by that date, the royalty period will continue until the cumulative royalty payments equal $16.7 million or until December 31, 2014, whichever comes first. After December 31, 2014, the contribution is forgiven. Royalties of $28,226 (2004 – $35,615) were recorded during the year.

b) In June 2001, the Company entered into an agreement with AVAC Ltd. ("AVAC") to provide funding for the Company's antibodies research. Under the terms of the agreement, AVAC will advance up to approximately $2.4 million on the basis of achieving specific predetermined milestones between June 2001 and May 2004. The advance is repayable in the form of a 3% royalty on gross revenues attributable to the commercialization of the antibody products. The cumulative royalty repayable is equal to two times the amount of funding received by the Company. For the year ended December 31, 2005, funding in the amount of $nil (2004 – $413,000) has been recorded as cost recoveries and $184,000 (2004 – $184,000) is included in accounts receivable. Subsequent to December 31, 2005, $184,000 has been received (2004 – $2,200,000).

c) In March 2003, the Company entered into an agreement with AVAC Ltd. to provide funding for the Company's Protein "A" research. Under the terms of the agreement, AVAC will advance up to $2.5 million on the basis of achieving specific predetermined milestones between March 2003 and March 2006. The advance is repayable in the form of a sliding scale royalty (1% to 3%) commencing March 2007. The cumulative royalty payable is equal to two times the amount of funding actually received by the Company. During the year ended December 31, 2003, the Company received funding of $1,150,000 under the agreement, of which the upfront payment of $750,000 was deferred and is being recognized over the contract term as the Company performs under the contract and milestones are achieved. For the year ended December 31, 2005, $249,996 (2004 – $249,996) of the upfront payment has been recorded as cost recoveries and $62,508 (2004 – $312,504) is recorded as deferred cost recoveries. An additional $248,000 (2004 – $nil) relating to milestones achieved in 2005 has been recorded as cost recoveries and is included in accounts receivable.

d) In October 2004, the Company entered into an agreement with a multinational food ingredient company to provide funding for the production of seed. Under the agreement terms, the multinational food ingredient company will advance up to US $74,500 to December 15, 2005. The advance is non-refundable and limited to the Company's expenses incurred in relation to this project. For the year ended December 31, 2005, funding in the amount of $59,994 (2004 – $28,107) has been recorded as cost recoveries, $nil (2004 – $41,558) is recorded as deferred cost recoveries and $nil (2004 – $71,205) is included in accounts receivable.

e) During the year, the Company received non-repayable financial assistance under various government programs in the amount of $150,846 (2004 – $230,046) which has been recorded as an expense reduction and $14,027 (2004 – $nil) is recorded as deferred cost recoveries.

6 Long-term debt

	2005 $	2004 $
Loan payable, bearing interest at bankers acceptance rate plus 4.43%, repayable in blended monthly instalments of $7,851, due November 2006	77,216	155,794
Loan payable, bearing interest at bankers acceptance rate plus 4.27%, repayable in blended monthly instalments of $3,613, due July 2007	64,879	102,375
Loan payable, bearing interest at bankers acceptance rate plus 4.12%, repayable in blended monthly instalments of $4,363, due November 2007	93,738	137,925
Loan payable, bearing interest at 10.4%, repayable in blended monthly instalments of US $21,757, due December 2008	774,559	–
Loan payable, bearing interest at 10.4%, repayable in blended monthly instalments of US $18,725, due December 2009	846,589	–
Other, non-interest bearing, repayable in monthly instalments of $1,130, due June 2007	20,349	33,915
	1,877,330	430,009
Less: Current portion of long-term debt	(590,243)	(173,683)
Balance – End of year	1,287,087	256,326

Repayment of long-term debt over the next four years is as follows:

	$
2006	590,243
2007	534,781
2008	506,742
2009	245,564
	1,877,330

The loans are collateralized by certain laboratory and other equipment.

7 Licensing fees and contract research

a) In December 2003, the Company entered into a collaboration agreement with Martek Biosciences Inc. ("Martek") relating to the development of transgenic plants to produce docosahexaenoic acid ("DHA"). As part of the agreement, Martek agreed to advance to the Company US$500,000 to assist with the working capital requirements of the project for the first year. In accordance with the Company's accounting policy, the advance is being recognized over the initial term of the collaborative research program. During the year ended December 31, 2005, $260,351 (2004 – $195,264) has been recognized as contract research revenue in relation to this advance and $195,259 (2004 – $455,610) is recorded as deferred revenue.

b) In April 2004, the Company entered into a technology licensing agreement granting Lonza Inc. an exclusive right in the personal care market covering the license, production and sale of the DermaSphere™ Oleosome Technology. Under the terms of the agreement, the Company received a US$300,000 initial licensing fee and an additional US$300,000 licensing fee, which have been recognized over the period during which the company

expected to provide development and commercialization advice to Lonza Inc. In the year ended December 31, 2005, $581,599 (2004 – $174,998) has been recognized as license fee revenue. The company will receive future royalties based on product sales in accordance with the terms of the license.

c) In May 2004, the Company entered into a development and license agreement with Arcadia Biosciences, Inc. ("Arcadia"), a private agricultural biotechnology company, for the development of gamma linolenic acid ("GLA"). Under the terms of the agreement, the Company granted Arcadia an exclusive license and received an upfront license fee of US$246,000. The license fee is being recognized as revenue over the term of the research and development period. In the year ended December 31, 2005, $171,015 (2004 – $166,018) has been recognized as license fee revenue. The Company also receives contract research payments, and is eligible for license fees and milestone payments as well as royalties on product sales by Arcadia.

d) In October 2004, the Company entered into a license and supply agreement with CytoStore Inc. for the development of research kits. Under the terms of the agreement, the Company granted an exclusive license and received an upfront license fee of $12,500. The license fee has been recognized as revenue over the term of the development period. In the year ended December 31, 2005, $10,417 (2004 – $2,083) has been recognized as license fee revenue. The Company will receive future royalties based on gross profits on product sales with minimum royalty requirements in accordance with the terms of the agreement.

8 Convertible promissory note

During 2003, the Company received US$2.25 million from Syngenta Participation AG in exchange for a convertible promissory note. The note bore interest on the unpaid balance at the rate of 8% per annum. On November 15, 2004, the company converted the US$2.25 million promissory note and accrued interest into common shares (note 9(b)) and common share purchase warrants (note 9(d)).

9 Capital stock

a) Authorized

Unlimited number of common shares without nominal or par value.
Unlimited number of First Preferred Shares without nominal or par value.

b) Issued – Common Shares

	Number of shares	Amount $
Balance – December 31, 2003	5,397,105	6,017,865
Exercise of stock options	67,564	42,228
Issuance of units	3,500,000	17,500,000
Conversion of promissory note *(note 8)*	465,051	2,918,208
Conversion of preferred share units	2,638,932	15,274,539
Share issue costs	–	(2,294,022)
Warrant value *(note 9(d))*	–	(3,839,119)
Balance – December 31, 2004	12,068,652	35,619,699
Exercise of stock options	101,378	63,361
Issuance of units	4,389,000	18,081,000
Share issue costs	–	(1,213,315)
Warrant value *(note 9(d))*	–	(4,447,036)
Balance – December 31, 2005	16,559,030	48,103,709

Issued – Class A Preferred Share Units

	Number of shares	Amount $
Balance – December 31, 2003	2,638,932	15,274,539
Conversion to common shares	(2,638,932)	(15,274,539)
Balance – December 31, 2004 and 2005	–	–

The share, option and warrant information has been retroactively adjusted to reflect the one-for-ten consolidation.

On June 21, 2004, in anticipation of a public offering, the shareholders of the Company approved a one-for-ten consolidation of all its common and preferred shares and preferred share warrants in connection with the public offering. In addition, a similar consolidation was affected on all outstanding common share options. All disclosures of outstanding shares, options, and warrants, as well as per share information, have been retroactively adjusted to reflect the consolidation.

On December 6, 2004 the Offering was completed and the following transactions were completed prior to the closing:

A Share Capital Reorganization was executed by: (i) completing a consolidation of shares; (ii) exchanging, on a ten-to-one basis, all of the Company's Class A convertible preferred shares into newly created Series P special shares and after the consolidation, converting those Series P special shares into common shares on the basis of 1.3793103 common shares for each Series P special share; (iii) exchanging, on a ten-to-one basis, the common shares held by certain founding shareholders into newly created Series C special shares and after the consolidation, converting those Series C special shares into common shares on the basis of 0.7784512 common shares for each Series C special share; (iv) converting all the Company's outstanding preferred share purchase warrants into common share purchase warrants; (v) terminating the shareholders' agreement dated October 17, 2000; and (vi) cancelling the Company's existing Class A convertible preferred shares and the special shares as authorized classes of shares and creating a class of first preferred shares, issuable in series. On November 15, 2004, the Company received a notice to convert a US$2.25 million promissory note held by Syngenta into 465,051 common shares (post consolidation) and 67,472 common share purchase warrants (post consolidation).

The Company entered into an Underwriting Agreement dated November 24, 2004 under which it agreed to file a prospectus to qualify for distribution of 3,500,000 units to be issued from treasury at $5.00 per unit (the "Offering"). Each unit consists of one common share and one-half of one common share purchase warrant. Each whole share purchase warrant entitles the holder to purchase one common share at a price of $6.25 per share. The agreement provides for an underwriters' fee of $0.26232 per unit (excluding fees payable for common shares and share purchase warrants sold pursuant to the over-allotment option) and the granting of an option to the underwriters to purchase up to an additional 525,000 common shares at $4.99 per share and 262,500 share purchase warrants at $0.01 per share purchase warrant, solely to cover over-allotments, if any, and for market stabilization purposes.

The Offering closed on December 6, 2004, with the 3,500,000 units being fully subscribed at a price of $5.00 per unit, resulting in gross proceeds of $17,500,000. Each whole share purchase warrant entitles the holder to purchase one common share at a price of $6.25 at any time prior to the date that is two years following December 6, 2004.

On January 7, 2005, the underwriters of the Offering exercised the entire over-allotment option and purchased an additional 525,000 common shares and 262,500 warrants resulting in gross proceeds of $2,625,000.

On December 20, 2005, pursuant to a private placement, the Company issued 3,864,000 units at an issue price of $4.00 per unit for gross cash proceeds of $15,456,000. Each unit consists of one common share and one-half of one common share purchase warrant. Each whole common share purchase warrant entitles the holder to purchase one common share at a price of $5.50 at any time prior to the date that is 30 months following December 20, 2005.

In December 2004, the Company entered into an escrow agreement for 4,169,669 common shares and 398,407 common share warrants issued as part of the initial public offering. Under the agreement, 25% of the securities were released on December 6, 2004, 33 1/3% of the remaining securities were released June 6, 2005 and 50% of the remaining securities were released December 6, 2005. At December 31, 2005, 1,042,417 common shares (2004 – 3,127,252) and 99,602 common share warrants (2004 – 298,805) remained in escrow and will be released June 6, 2006.

c) Per share amounts

The weighted average number of shares outstanding during the year was 12,731,169 (2004 – 5,998,755). The effects of potentially dilutive instruments on loss per share are anti-dilutive and therefore have been excluded from the calculation of diluted loss per share.

d) Warrants

Under a Preferred Stock Purchase Agreement dated October 17, 2000, the Company issued preferred stock units at $0.6275 consisting of 26,389,322 Class A Preferred Shares and 0.145 Preferred Stock Warrant for each Preferred Stock issued resulting in the issuance of 3,826,451 warrants. On December 3, 2004, the number of preferred shares and Preferred Stock Warrants have been consolidated on a one-for-ten basis and were converted to common shares and common share warrants. Consequently the number of Preferred Stock Warrants have been reduced to 382,645. The Preferred Stock Warrants were valued at $1,128,000 using the Black-Scholes option pricing method, assuming a life of seven years, 35% volatility and an average risk-free interest rate of 5%. The warrants are exercisable at any time at an exercise price of $4.55 prior to October 17, 2007.

On November 15, 2004, the Company converted the convertible promissory note payable into 465,051 common shares and 67,432 warrants. The warrants are exercisable at an exercise price of $6.25 prior to December 6, 2006. The fair value of these warrants was not deemed material.

On December 6, 2004, the Company issued 3,500,000 units consisting of 3,500,000 common shares and 1,750,000 warrants. These common share warrants were valued at $3,839,119 using the Black-Scholes option pricing method, assuming a life of 2 years, 90% volatility and an average risk-free interest rate of 4.2%. The warrants are exercisable at an exercise price of $6.25 prior to December 6, 2006.

On January 7, 2005, the underwriters of the Offering (note 9(b)) exercised the entire over-allotment option and purchased an additional 525,000 common shares and 262,500 warrants resulting in gross proceeds of $2,625,000. These common share warrants were valued at $817,226 using the Black-Scholes option pricing method, assuming a life of 1.9 years, 90% volatility and an average risk-free interest rate of 4.2%. The warrants are exercisable at an exercise price of $6.25 prior to December 6, 2006.

On December 20, 2005, the Company issued 3,864,000 units consisting of 3,864,000 common shares and 1,932,000 warrants. These common share warrants were valued at $3,629,810 using the Black-Scholes option pricing method, assuming a life of 2.5 years, 90% volatility and an average risk-free interest rate of 3.85%. The warrants are exercisable at an exercise price of $5.50 prior to June 21, 2008.

e) Stock options

The Company adopted a stock option plan in 1998 under which it may grant options to employees, consultants, officers and directors of the Company. Under that plan, the Board of Directors sets the exercise price and expiry date for each option grant. The options vest over a period of one to five years. On May 3, 2005, the shareholders approved a change to the stock option plan authorizing up to 12.5% of common shares for grant under the stock option plan.

The following table summarizes the stock option activity during the year:

	2005		2004	
	Stock options	Weighted average exercise price $	Stock options	Weighted average exercise price $
Outstanding – Beginning of year	812,659	1.05	649,096	0.63
Granted	228,200	5.78	285,208	1.84
Exercised	(101,378)	0.63	(67,564)	0.63
Forfeited	(12,842)	0.63	(54,081)	0.63
Outstanding – End of year	926,639	2.27	812,659	1.05

The following table summarizes information about stock options outstanding at December 31, 2005:

	Options outstanding			Options exercisable	
Range of exercise prices	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
$0.63	578,439	2.57	0.63	390,235	0.63
$3.50 – $6.50	348,200	6.22	5.00	41,500	4.13
	926,639	3.94	2.27	431,735	0.96

The fair value of stock options has been estimated on the date of grant by reference to the Black-Scholes option-pricing model using the following weighted average assumptions:

	2005	2004
Risk-free interest rate	4.5%	4.5%
Expected hold period to exercise	7 years	7 years
Volatility in the price of the Company's shares	70%	0%
Dividend yield	–	–
Weighted average fair value of options	4.04	0.39

Compensation expense related to options granted to employees in the year of $131,384 was recorded with an offsetting credit to contributed surplus. The fair value of options granted during the year ended December 31, 2004 was not material.

10 Income taxes

The Company's income tax provision has been determined as follows:

	2005 $	2004 $
Net loss for the year	6,824,545	5,692,493
Combined basic federal and provincial income tax recovery of 33.62% (2004 – 18.17%)	(2,294,412)	(1,034,326)
Permanent non-deductible expenses	58,378	40,093
Loss and temporary differences for which no benefit was recognized	2,236,034	994,233
	–	–

Based on an expected future tax rate for public companies of 33.62% (2004 – 33.62%), the significant components of the Company's future income tax assets are summarized as follows:

	2005 $	2004 $
Benefit of unclaimed current and capital scientific research and experimental development expenditures	7,672,399	5,565,761
Non-capital loss carryforwards	1,316,994	1,004,917
Benefit of investment tax credits	1,654,517	854,518
Capital assets	210,089	166,987
Share issuance costs	789,088	617,000
Future income tax asset	11,643,087	8,209,183
Less: Valuation allowance	(11,643,087)	(8,209,183)
	–	–

The Company has recorded a full valuation allowance against its future income tax assets because of its history of net operating losses since its inception.

The unutilized scientific research and experimental development expenditures may be carried forward indefinitely by the Company to reduce taxable income in future years. The non-capital loss carryforwards can be applied to reduce taxable income in the future. Tax losses of $1,181,101, $942,377 and $1,793,815 expire if not used before December 31, 2009, 2011 and 2012 respectively. Unutilized investment tax credits will expire in 10 years.

11 Commitments

The Company has entered into operating leases for laboratory equipment, a corporate head office and a secondary facility ending in 2011 as well as for computers and furniture. The minimum lease payments for the next five years and thereafter are as follows:

	$
2006	494,754
2007	502,046
2008	501,186
2009	492,347
2010	492,347
Thereafter	378,202

12 Financial instruments

Fair value

The fair values of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities and repayable advances approximate their carrying values due to their short-term maturity. The variable interest rate long-term debt fair value approximates its carrying value due to the debt bearing interest at a variable rate. The fixed interest rate long-term debt fair value, based on market interest rates, is $1,625,233 versus the carrying value of $1,621,148.

Credit risk

The Company is exposed to credit risk in the event of non-performance by counterparties, but does not anticipate such non-performance. The Company monitors the credit risk and credit standing of counterparties on a regular basis. The maximum credit risk is the fair value of the financial assets. Accounts receivable totalling $1,122,715 is due from four customers.

13 Segmented information

The Company is focused on the development, commercialization and production of biopharmaceutical proteins and non-pharmaceutical products based on its plant genetic engineering skills and its proprietary oilbody-oleosin technology platform.

At its current stage of development, the Company is only engaged in research and development. It derives its current revenues from licensing fees and contract research, both of which are closely connected with its primary research and development activities. In the opinion of management, the Company has only one business segment.

All assets are located in Canada and revenues from external customers are attributable to the following countries, based on the customer's country of domicile:

	2005 $	2004 $
License fees		
Canada	10,417	–
United States	752,614	343,099
Contract research revenue		
United States	1,646,079	1,082,679
Switzerland	50,092	42,090
	2,459,202	1,467,868

CORPORATE INFORMATION

Directors

Richard Smith
Former President & CEO,
Dow AgroSciences Canada, Inc. and
Chairman of the Board
(Retired from Dow in December 2005)

Andrew Baum
President & CEO
SemBioSys Genetics Inc.

Paul Cataford
President & CEO
University Technologies International Inc.

David Cox
President & CEO
Quest PharmaTech Inc.

Douglass Given
Partner
Bay City Capital

Nancy Harrison
Former Senior Vice President,
Ventures West Management Inc.
(Retired from Ventures West in December 2005)

David Howard
Chairperson
Angiotech Pharmaceuticals, Inc.

Hartley T. Richardson
President and CEO,
James Richardson & Sons Limited

Management

Andrew Baum
President & Chief Executive Officer

Maurice Moloney
Chief Scientific Officer

James Szarko
Chief Financial Officer

Joseph Boothe
Director, Biochemistry

Harm Deckers
Director, Intellectual Property

Nancy Markley
Director, Business Development

Steven Szarka
Director, Cell and Molecular Biology

Sharilyn Weisbeck
Controller

Janis Goll
Manager, Research Operations

Rick Keon
Manager, Planting Operations
& Field Regulatory Affairs

Karen Sparrow
Manager, Investor Relations

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Shares and Warrants are listed on the Toronto Stock Exchange under the symbol SBS and SBS.WT

Annual General Meeting

May 2nd, 2006 at 2:00pm
Calgary, Alberta